No. 14737

In the United States Court of Appeals for the Ninth Circuit

A. G. HOMANN, *Petitioner*
v.
COMMISSIONER OF INTERNAL REVENUE, *Respondent*

ANNA HOMANN, *Petitioner*
v.
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ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

TAXPAYERS' REPLY BRIEF

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SUMMARY OF ARGUMENT

I

In the taxpayers' opening brief it is urged that the Tax Court erred in the determination that the 68 houses sold in the year 1946 were held for sale to customers in the

ordinary course of business and the gain resulting was taxable as ordinary income. For the reasons urged in the opening brief, taxpayers urged that the Tax Court erred in this respect.

II

In the Commissioner's petition for review, reversal is sought of the Tax Court's finding that the taxpayers' basis for the 68 houses should be reduced by depreciation. In the Tax Court the Commissioner conceded that if the houses were held by the taxpayers for sale in the ordinary course of business that the tax basis should not be reduced by allowable depreciation. This question was not argued by the taxpayers in the Tax Court and the Tax Court's finding in this respect was invited by the Commissioner and cannot now be argued as grounds for reversal.

III

Commissioner's petition also asserts error in the Tax Court's finding that the sale of salvage material removed from the houses resulted in ordinary income.

Taxpayers maintain, however, that the Tax Court correctly held the proceeds from the salvage sale of the equipment removed from the houses resulted in capital gain and not ordinary income because taxpayers were never in the business of selling such salvage material.

ARGUMENT

The Gain Realized by the Taxpayers on the Sale of 68 Houses and Lots in the Calendar Year 1946 Is Taxable as Capital Gain under Section 117 of the Internal Revenue Code of 1939.

The Commissioner relies upon *Rollingwood v. Commissioner,* 190 F. 2d 263 (9th Cir.), but factually the relationship with the instant case is remote indeed. Bohannon, the principal in the *Rollingwood* case, had a controlling stock interest in the Rollingwood Corporation, and the Court of Appeals pointed out that Bohannon's business before the outbreak of the war was that of constructing homes, subdividing and selling real property. The sale of the Rollingwood houses was not to preserve a rental investment but to continue in the business of building homes for sale.

While Homann never before or since built houses for his own account or for sale to others, the important thing is that his purpose in building the houses was to obtain a rental investment which was thwarted by circumstances beyond his control. In consequence of which he was obliged to liquidate his investment in the Sunnyside houses in order to save the Olympia building which has proved a desirable rental investment and which he still has.

The 7th Circuit decided *Chandler v. U. S.* on October

14, 1955 (1955 C.C.H. par. 9691) in which the conclusion was reached in harmony with the cases cited by taxpayers that the question whether the property was held primarily for sale to customers is a conclusion of law or a mixed question of law and fact. It was further held that in a desire to liquidate an unprofitable holding of a million acres, the fact that the taxpayer made many separate sales, was not significant.

II

The Tax Court Correctly Held That if the Houses Were Held Primarily for Sale that the Taxpayers' Basis Should Not Be Reduced By Allowable Depreciation.

The Commissioner's brief (P. 21) quotes a portion of the finding of the Tax Court on the question of depreciation (R. 25) but significantly omits the all important concluding sentence. The complete finding is as follows:

> "By the same token, however, respondent erred in reducing petitioner's basis on account of depreciation "allowable." Since we have concluded that from the inception petitioner held the property primarily for sale it would not qualify for the "use in trade or business" requirement of the depreciation deducton. In fact, we do not read respondent's contentions as seriously opposing this view." (P.25) (Underscoring supplied).

The Commissioner's contention is untenable for two reasons. First, if erroneous, it is invited error and second,

is was urged below.

This case was not argued orally in the Tax Court, but, after the testimony was completed, was submitted entirely upon written briefs. The section of the Commissioner's brief dealing with the question of depreciation is reprinted herein as "Appendix A."

The position taken by the Commissioner is significantly stated in this paragraph:

> "The petitioner took no depreciation on the houses in the year 1945 or the year 1946. This, of course, is in full accord with respondent's theory of this case since if the the houses were held primarily for sale no depreciation could be taken. The statutory notice of deficiency has thereby reduced the basis by the amount of the depreciation allowed or allowable and this was done merely by way of protecting the revenues since, if the petitioner is sustained in his argument that the houses were property used in the trade or business, the depreciation should have been taken." (Underscoring supplied).

With this view the taxpayer agrees and consequently had no reason for discussing the question of depreciation in either the opening or reply briefs in the Tax Court.

It is readily conceded that if the ultimate decision is that the property was held for investment and not for sale to taxpayers' customers in the ordinary course of business, that the allowable depreciation must be taken into account in determining the gain. On the other hand, if the Tax

Court's conclusion is correct that the houses were held for sale to the taxpayers' customers in the ordinary course of business, then that is the very antithesis of the finding that the houses were held for the production of income and depreciation cannot be taken into account in determining the gain. That is the gist of the Tax Court's decision and the Commissioner in his brief categorically stated that if the houses were held primarily for sale no depreciation could be taken and consequently in the concluding sentence of the finding, the Tax Court observed:

> "In fact, we do not read respondent's contentions as seriously opposing this view."

The Commissioner may not take one position in the Tax Court and then urge on review here a completely antogonistic theory. This Court said in *U. S. v. Waechter,* 195 F. 2d 963:

> "We agree that the Government, whatever may be the strength of its present argument, cannot fairly urge as a ground for reversal a theory which it did not present while the case was before the trial court."

See also *Inman-Paulsen Lumber Company v. C. I. R.,* 219 F. 2d 159.

Moreover, if erroneous, the error was invited and invited error is not ground for reversal, *Capella v. Zurich General Accident Liability Insurance Company,* 194 F.

2d 588; *Orenstein v. U. S.*, 191 F. 2d 181; *Smails v. O'-Malley*, 127 F. 2d 410; *Reidy v. Myntti*, 116 F. 2d 725.

A party, including the United States, cannot urge error on a ruling or judgment made with express or implied consent, *United States v. Star Construction Co.*, 186 F. 2d 666(C. A. 10th; 1951).

III

The Tax Court Correctly Found that the Proceeds from the Salvage Sale of Equipment Removed from the Houses Resulted in Capital Gain and Not Ordinary Income.

Proceeds from the salvage sale of furnaces, refrigerators and ranges removed from houses resulted in capital gain rather than ordinary income.

The houses upon completion were equipped with ranges and refrigerators. Some purchasers or tenants had their own ranges or refrigerators and did not desire to purchase others, in consequence of which such items were removed and sold for whatever salvage they would bring.

The original furnaces in the houses all proved defective and were removed after causing two hostile fires and replaced with suitable heating equipment. The defective furnaces were sold which resulted in some salvage. Upon the undisputed proof in this connection, the Tax Court made the following finding:

> "In placing some of the properties in proper condition it apparently became necessary for petitioner to remove some furnaces, ranges and refrigerators. These were subsequently sold for their salvage value and respondent insists that this income also is ordinary income and not capital gain. We are unable to agree.
>
> Whatever petitioner's business as builder, developer and seller of finished houses, he was clearly not in the business of selling used or secondhand equipment. These items were not held for sale in the ordinary course of petitioners' business." (R. 26).

The taxpayers have never been engaged in the business of selling such salvage material either before or since. The Tax Court's finding that the profit resulting from the sale of that salvage was a capital gain and taxable as such and not ordinary income should be affirmed.

CONCLUSION

Taxpayers respectfully submit that the Tax Court erred in determining that the 68 houses were held primarily for sale in the ordinary course of business and that consequently the gain resulting from the sale was taxable as ordinary income and not at the capital gains rate. If the Tax Court is reversed on the foregoing primary proposition, then the gain should be reduced by the "allowable" depreciation. On the other hand, if the Tax Court is affirmed on the primary question, then it should like-

wise be affirmed in its finding that the tax basis should not be reduced by depreciation. In any event, the Tax Court's conclusion that the taxpayers were never in the business of selling secondhand ranges, furnaces and refrigerators, is manifestly correct and its conclusion that the income resulting from such salvage sales is taxable at the capital gain rate should be affirmed.

Respectfully submitted,
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APPENDIX A

EXCERPT FROM THE COMMISSIONER'S BRIEF
Filed in the Tax Court, February 18, 1954

A. *In the event it is held that the houses sold by petitioner in the year* 1946 *were not held primarily for sale in the ordinary course of petitioners' business then the basis of the houses sold must be reduced by the amount of the depreciation allowed or allowable. In any event, since the record shows that two houses were sold subsequent to the taxable year, the basis must be adjusted to eliminate that portion of the houses which remained unsold at the end of the taxable year.*

The petitioner took no depreciation on the houses in the year 1945 or the year 1946. This, of course, is in full accord with respondent's theory of this case since if the houses were held primarily for sale no depreciation could be taken. The statutory notice of deficiency has thereby reduced the basis by the amount of the depreciation allowed or allowable and this was done merely by way of protecting the revenues since, if the petitioner is sustained in his argument that the houses were property used in the trade or business, the depreciation should have been taken.

Before discussing the case law with regard to this particular point it is hereby pointed out that the Court's holding on the major issue in this case could influence the decision on this issue in still another way. If, for example, the Court should hold that the houses were held primarily for sale—starting in 1946—then the respondent should be sustained on the depreciation issue as to 1946 and the basis should be reduced accordingly. The respondent has contended in the major argument that the houses were either always held for sale or that the purpose in holding the houses changed so that in any event they were held for sale at the time of their disposal.

Section 23(1) of the Internal Revenue Code provides for the deduction of depreciation by saying that the

taxpayer may deduct from gross income in arriving at net income a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business. Section 111 of the Internal Revenue Code provides that in computing gain or loss the gain or loss shall be the excess of the amount realized over the adjusted basis provided in section 113 (b) of the Internal Revenue Code. Section 113—which contains the basis provisions—first provides under subsection (a) that the unadjusted basis shall be cost. Under subsection (b) the adjustments are made which result in the adjusted basis which is what we are here concerned with. Section 113 (b) (1) (B) provides that in arriving at adjusted basis the taxpayer shall make an adjustment for depreciation to the extent allowed but not less than the amount allowable. The reason for this is obvious. It precludes the taxpayer from taking advantage in a later year of his prior failure to take any depreciation allowance. See Regulations 29.23(1)-5.

Under the authority of *Virginian Hotel Corporation v. Helvering* (1943) 319 U. S. 523 /30 A.F.T.R. 1304/, if the property in the instant case is held by this Court to be property used in the trade or business either in 1945, 1946 or both years then the respondent's action in reducing the basis by this amount must be sustained at least as to the year in which the property was so held.